SUPREME COURT, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. 959

REUBEN B. WHEATLEY, Commissioner of Finance,
Petitioner

v.

CHICAGO BRIDGE & IRON COMPANY, LTD.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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PYLE OF DUDLEY S. ADAMS PRINTERS, INC., WASHINGTON, D. C.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

The Attorney General of the Virgin Islands, on behalf of Reuben B. Wheatley, Commissioner of Finance of the Virgin Islands, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Third Circuit in this case.

OPINIONS BELOW

The opinion of the district court (Appendix A, *infra*, pp. 1a-6a) is reported at 395 F. Supp. 240. The opinion of the court of appeals (Appendix B, *infra*, pp. 7a-16a) is not yet reported.

JURISDICTION

The judgment of the Court of appeals was entered on July 13, 1970 (Appendix C, *infra*, p. 17a). By order dated October 6, 1970, Mr. Justice Brennan extended the time for filing a petition for a writ of certiorari to and including November 11, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254 (1).

QUESTION PRESENTED

Whether, under the Internal Revenue Code as applied to the Virgin Islands, a Delaware corporation is a "domestic corporation" and is thus entitled to a Western Hemisphere trade corporation deduction.

STATUTES INVOLVED

The pertinent provisions of the Naval Service Appropriation Act of July 12, 1921, and the Internal Revenue Code of 1954 are set forth in Appendix D, *infra*, pp. 18a-19a.

STATEMENT

Chicago Bridge & Iron Company, Ltd. ("CB&I"), a Delaware corporation, derives substantially all of its gross income from sources without the United States, including the Virgin Islands. Since Congress has adopted the United States Internal Revenue Code as the Virgin Islands tax law,[1] CB&I admittedly is taxable in the Virgin Islands on all of its income derived from Virgin Islands sources even though it is not in-

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[1] Naval Service Appropriation Act of July 12, 1921, c. 44, 42 Stat. 122, 123, as codified in the Revised Organic Act of the Virgin Islands, 48 U.S.C. 1397, and set forth in Appendix D, *infra*, p. 18a. See *Dudley* v. *Commissioner*, 258 F.2d 182, 185 (C.A. 3); I.T. 2946, XIV-2 Cum. Bull. 109, 110.

corporated there, just as a nonresident of the United States or a foreign corporation is taxable by the United States on all income from United States sources.

In 1965 CB&I reported and paid to the Virgin Islands taxes on its income derived from the Virgin Islands. CB&I claimed the special Western Hemisphere trade corporation ("WHTC") deduction under Sections 921 and 922 of the Internal Revenue Code (Appendix D, *infra*, pp. 18a-19a), the practical effect of which is to reduce the applicable income tax rate for any corporation qualifying as a WHTC from 48 percent (the general rate) to 34 percent. CB&I's right to this deduction is disputed here.

A WHTC is defined in Section 921 as (1) a "domestic corporation," (2) substantially all of whose business is done in certain Western Hemisphere countries, (3) at least 95 percent of whose gross income is derived from "sources without the United States," and (4) at least 90 percent of whose gross income is derived "from the active conduct of a trade or business." Only the first of these four requirements is in issue.

CB&I claims that it is a "domestic corporation" for Virgin Islands tax purposes, and is therefore entitled to the WHTC deduction, in reliance on Section 7701 (a)(4) and (5) of the Code (Appendix D, *infra*, p. 19a). Section 7701(a)(4) provides that: "The term 'domestic' when applied to a corporation . . . means created or organized in the United States or under the law of the United States or of any State or Territory."[2] A "foreign" corporation is defined in Sec-

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[2] The Virgin Islands is a possession, not a territory, of the United States, and thus corporations organized under its law are not "domestic" to the United States for purposes of the United States income tax. See Rev. Rul. 56-616, 1956-2 Cum. Bull. 589.

tion 7701(a)(5) as any corporation "which is not a domestic corporation." However, because the Internal Revenue Code as written is directed to the imposition and collection of taxes by the United States from United States citizens and United States sources, it was recognized early that "it will, of course, be necessary in some sections of the law to substitute the words 'Virgin Islands' for the words 'United States', in order to give the law proper effect in those islands"; and that "[f]rom the viewpoint of the Virgin Islands citizens of the United States residing in the islands must be considered as resident aliens, and citizens of the United States not residing in the Virgin Islands must be treated as nonresident aliens." I.T. 2946, XIV-2 Cum. Bull. 109, 110.

In processing CB&I's claimed WHTC deduction, Virgin Islands tax authorities concluded that the analysis of I.T. 2946 was applicable. Accordingly, those authorities construed Section 7701(a)(4) and (5), as applied to the Virgin Islands, as providing that a corporation organized in the Virgin Islands is "domestic" while a corporation organized elsewhere is "foreign."[3] From this it followed, reading these definitions into the provisions of Sections 921 and 922 for Virgin Islands income tax purposes, that a WHTC deduction is available only to corporations organized in the Virgin Islands, and not to corporations, like CB&I, organized elsewhere. CB&I's deduction thus was disallowed. CB&I challenged this action by filing suit in the dis-

[3] This approach to the classification and tax treatment of nonresident "aliens" and "foreign" corporations for the purpose of a territorial income tax was expressly required for Puerto Rico and the Philippine Islands by Section 261 of the Revenue Act of 1918, c. 18, 40 Stat. 1057.

trict court, which upheld the disallowance (Appendix A, *infra*, pp. 1a-6a. On appeal, the Third Circuit reversed (Appendix B, *infra*, pp. 7a-16a).

REASONS FOR GRANTING THE WRIT

1. The decision below is squarely in conflict with that of the Ninth Circuit in *Sagre & Co. v. Riddell*, 395 F. 2d 407. In that case the Ninth Circuit construed the Internal Revenue Code as applied to Guam for purposes of the Guam income tax. Overruling an earlier decision,[4] a unanimous *en banc* court held that, for Guam income tax purposes, a "domestic corporation" within the meaning of Section 7701(a)(4) of the Code is a Guamanian corporation and that corporations organized elsewhere, specifically including United States corporations, are "foreign." In so holding, the court relied on Section 31 of the Organic Act[5] directing that in applying the Internal Revenue Code in Guam, those provisions "manifestly inapplicable or incompatible with the intent of this section" should be disregarded, and "Guam" should be substituted for "United States", and such "other changes in nomenclature and other language, including the omission of inapplicable language," should be made wherever necessary. 48 U.S.C. 1421i(d)(1) and (e). The reliance placed on Section 31 is particularly relevant here because, as the Ninth Circuit observed (395 F. 2d at 410-412), Congress intended in adopting that provision for Guam, to follow the approach earlier adopted for the Virgin Islands in I.T. 2946, *supra*.

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[4] *Atkins-Kroll (Guam), Ltd.* v. *Government of Guam*, 367 F. 2d 127, certiorari denied, 386 U.S. 933.

[5] Section 31 of the Organic Act of Guam, c. 512, 64 Stat. 384, 48 U.S.C. 1421i.

Although *Sayre* ultimately involved the application to Guam of Section 881 of the Code, and the instant case ultimately involves the WHTC provisions, in both the outcome turns on the proper classification of corporations as "domestic" or "foreign" under Section 7701(a)(4) and (5). *Sayre* held that United States corporations are "foreign" to Guam, while the court below held—directly to the contrary—that United States corporations are "domestic" to the Virgin Islands. Since in both cases the courts were interpreting the same section of the Internal Revenue Code, and since the legislative provisions whereby the Code is made applicable to Guam and the Virgin Islands are intended to provide comparable tax systems, the conflict thus posed is one that warrants this Court's review.

2. Because appellate review of Virgin Islands decisions may be had only in the Third Circuit (28 U.S.C. 1294(3)), the decision below, if not corrected by this Court, will be controlling for Virgin Islands tax purposes. That decision threatens the Virgin Islands' ability to raise revenues. At this time there are four United States corporations operating in the Virgin Islands that have claimed tax refunds totaling $411,000 on the basis of an asserted WHTC deduction. It is anticipated that additional claims will be made by other United States corporations and that existing Virgin Islands corporations will re-incorporate in the United States to obtain the benefit of the WHTC deduction. In all, it is estimated the revenue loss to the Virgin Islands resulting from this decision could exceed $7,000,000 a year, which constitutes over 30 percent of all corporation taxes, over 11 percent of all income taxes, and over 9 percent of taxes from all sources. See Appendix E, *infra,* pp. 20a-22a. Such a loss

would greatly impair the fiscal integrity of the Virgin Islands and thus do violence to the stated congressional intent of rendering the Islands self-supporting by means of the income tax.[6] Moreover, whether a corporation is "domestic" or "foreign" is basic to the entire Virgin Islands tax system,[7] and the holding below thus will have a substantial unsettling effect upon the administration of that system.

3. The Third Circuit misinterpreted the rationale of *Sayre*. It found (Appendix B, *infra*, p. 14a) that the basic scheme of the Code as applied to the Virgin Islands is to impose the same tax on a Virgin Islands taxpayer as the United States would impose on that taxpayer under the Code as applied to the United States. Since, for United States tax purposes, CB&I, a Delaware corporation, would qualify as a WHTC, and as such would be taxed at the reduced 34 percent rate, the court concluded that, for Virgin Islands tax purposes, CB&I must be considered a "domestic" corporation, so as to qualify as a WHTC and the reduced 34 percent rate. But *Sayre* rejected any such notion, specifically upholding Guam's imposition of a total tax substantially exceeding the tax which the United States would have imposed on the same taxpayer. Rather, as *Sayre* correctly emphasized (395 F. 2d at 412), the proper territorial application of the Code is evenhanded tax treatment, so that the taxation of a Virgin Islands taxpayer by the Virgin Islands

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[6] See 61 Cong. Record, Part 2, p. 1724; 61 Cong. Record, Part 3, p. 3173.

[7] Since the Internal Revenue Code is generally applicable to the Virgin Islands, the "domestic-foreign" classification is of decisive importance in numerous provisions. See, *e.g.*, Code Sections 243(d), 245, 301(6)(1)(C), 367, 881-884, 902, 951-964, 1246-1248 and 1504(6)(3).

will be comparable to the taxation of a similarly situated United States taxpayer by the United States. Evenhandedness thus requires that a United States corporation *not* be deemed a "domestic" corporation entitled to the reduced 34 percent tax rate for Virgin Islands tax purposes, just as a Virgin Islands corporation is *not* a "domestic" corporation and thus cannot qualify as a WHTC for United States tax purposes.

Under petitioner's construction of the WHTC provisions, a Virgin Islands corporation with only United States income would qualify for the WHTC deduction for Virgin Islands tax purposes. The court below thought (Appendix B, *infra*, p. 16a) that this construction conflicts with the congressional intent that the WHTC provisions benefit solely business outside the United States. But the court's analysis overlooks the fact that the Virgin Islands is a separate tax jurisdiction, and that, therefore, the congressional intent discerned by the court is relevant only for United States tax purposes.[8] Moreover, petitioner's construction achieves the evenhandedness which the Ninth Circuit in *Sayre* found to be the touchstone of the territorial tax system: a Virgin Islands corporation with only United States income is taxed at the WHTC 34 percent rate for Virgin Islands tax purposes, and at the general corporate rate of 48 percent for United States tax purposes; similarly, a United States corporation with only Virgin Islands income is taxed at the WHTC 34 percent rate for United States tax purposes, and

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[8] Equally inapposite is the court's reference (Appendix B, *infra*, pp. 14a-15a) to Rev. Rul. 55-105, 1955-1 Cum. Bull. 94, and I.T. 4067, 1951-2 Cum. Bull. 55, since these administrative interpretations of the WHTC provisions are relevant only for United States tax purposes.

at the general corporate rate of 48 percent for Virgin Islands tax purposes.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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NOVEMBER 1970.

APPENDIX A

IN THE DISTRICT COURT OF THE VIRGIN ISLANDS
DIVISION OF ST. THOMAS AND ST. JOHN

Civil No. 237-1967

CHICAGO BRIDGE & IRON COMPANY, LTD., *Petitioner*,

v.

REUBEN B. WHEATLEY, Commissioner of Finance,
Respondent.

ACTION FOR REDETERMINATION OF INCOME TAX LIABILITY

Opinion

This motion for judgment on the pleading comes before the court as a result of Chicago Bridge & Iron Company's suit for redetermination of its tax liability to the Virgin Islands for the year 1965. Respondent, Reuben B. Wheatley, Commissioner of Finance, disallowed to petitioner the Western Hemisphere Trade Corporation special deduction (Int. Rev. Code of 1954, § 922)[1] of $869.96 claimed by petitioner on its income tax return on the ground that such deduction is not allowable in determining Virgin Islands'

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[1] Section 922 provides:

"In the case of a Western Hemisphere trade corporation there shall be allowed as a deduction in computing taxable income an amount computed as follows—

"(1) First determine the taxable income of such corporation computed without regard to this section.

"(2) Then multiply the amount determined under paragraph (1) by the fraction—

"(A) the numerator of which is 14 percent, and

"(B) the denominator of which is that percentage which equals the sum of the normal tax rate and the surtax rate for the taxable year prescribed by section 11."

income tax to corporations which are not incorporated in (i.e., domestic corporations of) the Virgin Islands.

Under § 921 of the Internal Revenue Code of 1954, the § 922 deduction is available to

> "• • • a domestic corporation all of whose business (other than incidental purchases) is done in any country or countries in North, Central, or South America, or in the West Indies, and which satisfies the following conditions:
>
> "(1) if 95 percent or more of the gross income of such domestic corporation for the 3-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) was derived from sources without the United States; and
>
> "(2) if 90 percent or more of its gross income for such period or such part thereof was derived from the active conduct of a trade or business. • • •"

There is no dispute here that, for United States income tax purposes, petitioner, a Delaware corporation, is a domestic corporation within the meaning of § 921, since the Int. Rev. Code of 1954, § 7701(a)(4) provides:

> "The term 'domestic' when applied to a corporation or partnership means created or organized in the United States or under the law of the United States or of any State or Territory."

The critical question is whether petitioner is a domestic corporation within the meaning of § 921 for Virgin Islands tax purposes. This requires an understanding of the structure and etiology of the Virgin Islands tax law.

When Congress enacted the Naval Appropriation Act of July 12, 1921,[2] it provided:

> "• • • the income-tax laws now in force in the United States of America and those which may here-

[2] 42 Stat. 123, 48 U.S.C. § 1397.

after be enacted shall be held to be likewise in force in the Virgin Islands of the United States, except that the proceeds of such taxes shall be paid into the treasuries of said islands."

The effect of this statute was to create a "mirror" system of taxation whereby the United States tax law was reflected by the Virgin Islands tax law. As noted in Dudley v. Commissioner, 258 F.2d 182, 185 (C.A. 3, 1958), the statute set up two distinct taxing jurisdictions having as their basic law an identical taxing statute applicable to each. Under this system, a United States corporation doing business in the Virgin Islands had to file two tax returns: one in the Virgin Islands which had jurisdiction to tax all income from sources within the Virgin Islands, and one in the United States which had jurisdiction to tax all income from any source, including the Virgin Islands. Double taxation from the same income was avoided by allowing the taxpayer, in reporting to one taxing jurisdiction, to take a foreign tax credit for any taxes paid to the other taxing jurisdiction. See Int. Rev. Code of 1939 § 131(a)(1); Int. Rev. Code of 1954, § 901(b)(1); I.T. 2946, XIV-2 Cum. Bull. 109 (1935); I.T. 3690, 1944 Cum. Bull. 164.

This dual system of taxation was perpetuated by the Virgin Islands Government, when in 1957, it enacted 33 V.I.C. § 1931(15), which provides:

> "'Virgin Islands income tax law' means so much of the United States Internal Revenue Code as was made applicable in the Virgin Islands by the Act of Congress entitled 'An Act making appropriations for the naval service for the fiscal year ending June 30, 1922, and for other purposes,' approved July 12, 1921 (48 U.S.C. § 1397)."

It is petitioner's contention that under the mirror system of taxation, a United States corporation, such as

petitioner, is required to pay to the Virgin Islands only the same amount of tax on its Virgin Islands source income as would be due the United States on that same income. Thus, it is argued that since petitioner can claim the § 922 deduction on its United States income tax return, it should also be able to claim the same deduction on its Virgin Islands tax return. The court believes that this is an improper view of the dual taxing system. Cf. Jennings v. United States, 168 F. Supp. 781 (Ct. Cl. 1958).

As early as 1935, the Internal Revenue Service recognized in I.T. 2946, XIV-2 Cum. Bull. 109, that since the United States and the Virgin Islands are separate taxing jurisdictions,

> "• • •it will, of course, be necessary in some sections of the law to substitute the words 'Virgin Islands' for the words 'United States,' in order to give the law proper effect in those islands • • •"

This substitution approach has been followed by the district court of Guam in tax problems arising in that jurisdiction. Wilson v. Kennedy, 123 F. Supp. 156, 159 (Guam 1954), aff'd 232 F.2d 153 (C.A. 9, 1956); Government of Guam v. Kaanehe, 124 F. Supp. 15, 17 (Guam 1954). The same approach will be followed in the instant case because the court believes that under the mirror system of taxation, if the § 922 special deduction is available to corporations filing Virgin Islands income tax returns, it is only available to Virgin Islands "domestic" corporations within the meaning of 33 V.I.C. § 1931(2), which provides:

> " 'domestic' when applied to a corporation or partnership means created or organized in the Virgin Islands."

Petitioner was incorporated in Delaware, not the Virgin Islands; it is a United States domestic corporation under the Internal Revenue Code of 1954, § 1701(a)(4), and a

foreign corporation for Virgin Islands income tax purposes under 33 V.I.C. § 1931(5).[3] The court does not think it unusual that the Virgin Islands should consider a United States corporation as foreign when the Internal Revenue Service has held that for United States income tax purposes

> "a corporation formed under the laws of the Virgin Islands does not meet the definition of a domestic corporation as that term is defined in section 7701-(a)(4) of the Code, since such a corporation is not a corporation organized in the United States or under the law of the United States or of any State or Territory."[4]

The mirror system and basic fairness dictate that if the United States can treat Virgin Islands corporations as foreign, the Virgin Islands should be able to reverse the equation.

Furthermore, as observed by Judge Maris in Dudley v. Commission, supra at 185, the Congressional purpose in setting up a territorial income tax payable directly to the Virgin Islands, was "to assist the Islands in becoming self-supporting." This Congressional concern for the financial well-being of the Islands was again manifested by Congress in 1954 when it enacted the Revised Organic Act of the Virgin Islands, § 28a. 48 U.S.C. § 1642.[5] This

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[3] 33 V.I.C. § 1931(5) provides:

> "'foreign' when applied to a corporation or partnership means a corporation or partnership which is not domestic."

[4] Letter of former Commissioner of the Internal Revenue Service, Mortimer M. Caplin, responding to a letter dated July 17, 1963, from the Honorable Ralph M. Paiewonsky, Governor of the United States Virgin Islands.

[5] "The proceeds of customs duties, the proceeds of the United States income tax, the proceeds of any taxes levied by the Congress on the inhabitants of the Virgin Islands, and the proceeds of all quarantine, passport, immigration, and naturalization fees col-

statute had the effect of requiring permanent residents to pay tax to the Virgin Islands on all their income regardless of source. Thus, all taxes which had been previously paid by permanent residents to the United States on United States source income were made payable to the Virgin Islands treasury.

In light of Congress' benevolent intent with regard to the collection of revenue by the Virgin Islands and in accordance with the mirror system of taxation, the court holds that petitioner is not entitled to the special deduction under § 922 when filling its Virgin Islands income tax return. Judgment on the pleadings will be granted in favor of respondent.

STALEY
Circuit Judge
Sitting by designation.

Dated:
February 3rd, 1969

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lected in the Virgin Islands, less the cost of collecting all of said duties, taxes, and fees, shall be covered into the treasury of the Virgin Islands, and shall be available for expenditure as the Legislature of the Virgin Islands may provide: *Provided*, That the term 'inhabitants of the Virgin Islands' as used in this section shall include all persons whose permanent residence is in the Virgin Islands, and such persons shall satisfy their income tax obligations under applicable taxing statutes of the United States by paying their tax on income derived from all sources both within and outside the Virgin Islands into the treasury of the Virgin Islands. • • • " 48 U.S.C. § 1642.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 17,838

CHICAGO BRIDGE & IRON COMPANY Ltd., *Appellant*

v.

REUBEN B. WHEATLEY, Commissioner of Finance, *Appellee*

Appeal From the District Court of the Virgin Islands, Division of St. Thomas and St. John

Argued January 28, 1970

Before HASTIE, *Chief Judge*; and GANEY and STAHL,* *Circuit Judges.*

Opinion of the Court

(Filed July 13, 1970)

HASTIE, *Chief Judge:*

The basic issue presented on this appeal is whether a Delaware corporation is entitled to use the Western Hemisphere trade corporation deduction to reduce its income tax liability to the Virgin Islands.

The Internal Revenue Code of the United States was made applicable in the Virgin Islands by the Naval Service Appropriation Act of 1922, 48 U.S.C. § 1397 (1964):

> "The income-tax laws in force in the United States States of America and those which may hereafter be enacted shall be held to be likewise in force in the Virgin Islands of the United States, except that the proceeds of such taxes shall be paid into the treasuries of said islands."

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* Judge Stahl heard the argument and participated in the consideration of this appeal but died before decision.

Beyond merely extending the geographic coverage of the Internal Revenue Code, this statute in effect created a separate territorial income tax measured by that Code and to be collected by the Government of the Virgin Islands. *Dudley* v. *Commissioner*, 3d Cir. 1958, 258 F.2d 182, 185.

The Virgin Islands has jurisdiction to tax corporations of mainland domicile on income from sources within the Virgin Islands. At the same time the United States has jurisdiction to tax the income of such corporations regardless of source, and does so. Double taxation is avoided by granting a foreign tax credit to such corporations for taxes paid to the Virgin Islands. *See* I.T. 2946, XIV-2 CUM. BULL. 109, 110 (1935).[1]

Section 922 of the Internal Revenue Code of 1954 provides a special deduction for "Western Hemisphere trade corporations" in computing taxable income, and section 921 defines corporations entitled to the special deduction:

> "For purposes of this subtitle, the term 'Western Hemisphere trade corporation' means a domestic corporation all of whose business (other than incidental purchases) is done in any country or countries in North, Central, or South America, or in the West Indies, and which satisfies the following conditions:
>
> (1) if 95 percent or more of the gross income of such domestic corporation for the 3-year period im-

[1] In 1954, Congress provided that permanent residents of the Virgin Islands (including Virgin Islands corporations) must return and pay taxes to the Virgin Islands on income from all sources. Revised Organic Act of the Virgin Islands § 28(a), 48 U.S.C. § 1642 (1964). However, corporations domiciled on the mainland and United States citizens not residing permanently in the Virgin Islands must still file two tax returns, one reporting and paying taxes to the Virgin Islands on Virgin Islands income, and the other reporting and paying taxes to the United States on income from all sources, with a credit for taxes paid to the Virgin Islands.

mediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) was derived from sources without the United States; and

(2) if 90 percent or more of its gross income for such period or such part thereof was derived from the active conduct of a trade or business.

. . . "

The Virgin Islands are considered to be a "country . . . in the West Indies" and a source of income "without the United States" in the administration of this special provision. Rev. Rul. 55-105, 1955-1 CUM. BULL. 94; I.T. 4067, 1951-2 CUM. BULL. 55-56. In addition, section 7701(a)(4) of the 1954 Code defines a "domestic" corporation as one "created or organized in the United States or under the law of the United States or of any State or Territory." But Virgin Islands corporations are not "domestic" under the definition in section 7701(a)(4) because the term "Territory" in that section includes only incorporated territories, such as Alaska and Hawaii before they were admitted to the Union. *See* Treas. Reg. § 301.7701-5 (1960). The Virgin Islands are an unincorporated territory, 48 U.S.C. § 1541(a) (1964), and a Virgin Islands corporation is treated as "foreign" for purposes of the United States income tax. *See* Rev. Rul. 56-616, 1956-2 CUM. BULL. 589-90.

It is undisputed, therefore, that the taxpayer would be entitled to the special deduction of section 922 on its United States income tax return, since the taxpayer is a domestic corporation of the United States and satisfies the conditions of clauses (1) and (2) of section 921 for the taxable year at issue. However, the Commissioner of Finance disallowed the Western Hemisphere trade corporation deduction claimed in the taxpayer's Virgin Islands income tax return and determined a deficiency on the ground

that the deduction is not allowable in a Virgin Islands return to corporations that are not "domestic" in relation to that taxing authority. On the taxpayer's suit for redetermination, the district court reached the same result as the Commissioner by reading a definition of "domestic" found in the Virgin Islands Code, 33 V.I.C. § 1931(2) (1967), into the Internal Revenue Code's definition of a Western Hemisphere trade corporation. The local statute defines "domestic" when applied to a corporation to mean "created or organized in the Virgin Islands." Relying upon this definition, the district court ruled that only Virgin Islands corporations, and not mainland corporations like the taxpayer, are entitled to the special deduction allowed by section 922 when computing their income tax liability to the Virgin Islands. *Chicago Bridge & Iron Co.* v. *Wheatley*, D.V.I. 1969, 295 F. Supp. 240, 242.

We think that the district court erred in relying on the definition of "domestic" in section 1931 of the Virgin Islands Code. Congress has not empowered the Virgin Islands Legislature to redefine terms in the Internal Revenue Code, and in section 1931 that Legislature has not purported to do so. Indeed, the definitions in that section apply by their own terms only "[w]hen used in this subtitle," namely, Subtitle 1 of Title 33. Of course, the substantive provisions of the Internal Revenue Code of 1954 are not incorporated into Subtitle 1 of Title 33 or any other part of the Virgin Islands Code.[2] Thus, the pertinent inquiry is whether, absent any authoritative local legislation, the Commissioner's construction of "domestic" in section 921

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[2] Subtitle 1 of Title 33 contains two parts. Part I sets forth the substantive provisions of certain locally imposed taxes, such as inheritance, excise, gasoline, stamp, and production taxes. Part II comprises procedural and administrative provisions applicable to all Virgin Islands taxes, including the United States income tax. As pointed out in the text at the beginning of this opinion, the substantive provisions of the Internal Revenue Code were made applicable in the Virgin Islands by congressional enactment in the Naval Service Appropriation Act of 1922, 48 U.S.C. § 1397 (1964).

of the Internal Revenue Code as meaning only Virgin Islands corporations is required to give proper effect to the Western Hemisphere trade corporation deduction as part of the Virgin Islands income tax law.

Both the federal tax administrators and the Congress have recognized that implementation of the Internal Revenue Code as a separate taxing statute in the Virgin Islands requires some substitution of language. In a ruling published in 1935, the Bureau of Internal Revenue noted that in construing the taxing statute applicable in the Virgin Islands, "it will, of course, be necessary in some sections of the law to substitute the word 'Virgin Islands' for the word 'United States,' in order to give the law proper effect in those islands." I.T. 2946, XIV-2 CUM. BULL. 109, 110 (1935).[3]

The Internal Revenue Code was enacted as the income tax law of Guam by section 31 of the Organic Act of Guam in language identical in all relevant respects to the statute that had established what has come to be called the "mirror system" of taxation in the Virgin Islands.[4] The equivalent mirror system of taxation in Guam has been the subject of congressional and judicial interpretations that indicate the extent to which the Internal Revenue Code should

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[3] The Senate Report on the 1960 amendments adding section 934 to the Internal Revenue Code of 1954 described this dual or mirror system of taxation applicable in the Virgin Islands in similar terms:

> "For many years . . . the income tax laws of the United States have been applicable to the Virgin Islands as if these laws had been separately enacted for the Virgin Islands, substituting the name 'Virgin Islands' for references to the United States in the income tax laws."

S. REP. No. 1767, 86th Cong., 2d Sess. 2 (1960), 1960-2 CUM. BULL. 829, 830.

[4] *Compare* 48 U.S.C. § 1421i(a) (1964) *with* 48 U.S.C. § 1397 (1964).

be modified in its application as a separate territorial income tax. The decisions construing the original Guamanian tax statute agreed that "[t]he tax to be paid ordinarily is measured by the amount of income tax the taxpayer would be required to pay to the United States of America if the taxpayer were residing in the continental United States," and that the literal terms of the Internal Revenue Code should be modified only by "those non-substantive changes in nomenclature as are necessary to avoid confusion as to the taxing jurisdiction involved."[5]

In 1958 Congress amended section 31 of the Organic Act of Guam to clarify the separate territorial income tax structure. In an explanatory note accompanying its recommendation that the amendments to section 31 be approved, the Committee on Interior and Insular Affairs recognized the similarity of the income tax structures of Guam and the Virgin Islands and indicated that the amendments would be in accordance with a number of authoritative pronouncements, among them the ruling of the Bureau of Internal Revenue that the same principles of substitution were applicable to the revenue laws of both possessions.[6] The amendments limited incorporation of the Internal Revenue Code in Guam to those provisions "not manifestly inapplicable or incompatible" with a separate territorial income tax, and provided for the substitution of "Guam" for "United States" and "other changes in nomenclature and other language, including the omission of inapplicable language, where necessary to effect the intent of this section." 48 U.S.C. § 1421i (d)(1) & (e) (1964). However, the

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[5] Wilson v. Kennedy, D. Guam 1954, 123 F. Supp. 156, 160, *aff'd*, 9th Cir. 1956, 232 F.2d 153. *See* Pacific Wholesalers, Inc. v. Mangerich, D. Guam 1957, 147 F. Supp. 867, 868; Guam v. Kaanehe, D. Guam 1954, 124 F. Supp. 15, 17; Laguana v. Ansell, D. Guam 1952, 102 F. Supp. 919, 921, *aff'd per curiam*, 9th Cir. 1954, 212 F.2d 207, *cert. denied*, 348 U.S. 830.

[6] 2 U.S. Code Cong. & Ad. News, 85th Cong., 2d Sess. 3651-53 (1958), *citing* I.T. 4046, 1951-1 Cum. Bull. 57.

apparent latitude for interpretation allowed by the amended statute has not changed the basic conception that "the purpose of the amended statute was to give Guam a separate, integral tax system, which would duplicate the United States' tax system in all substantive particulars." *Sayre & Co.* v. *Riddell*, 9th Cir. 1968, 395 F.2d 407, 410.

The principles by which the mirror system of taxation should be applied have received instructive exemplification in decisions interpreting the amended Guamanian tax statute. When the tax officials of Guam passed regulations purporting to disallow business losses in the United States as deductions on Guamanian income tax returns, and attempting to redefine gross income to include only income earned in Guam, the regulations were held invalid as modifying the substance of Internal Revenue Code provisions that were not "manifestly inapplicable or incompatible" with a separate tax structure. *Guam* v. *Koster*, 9th Cir. 1966, 362 F.2d 248. On the other hand, in *Sayre & Co.* v. *Riddell, supra*, it was held that Guam properly treated a United States corporation as foreign for the purpose of the withholding tax on payments to foreign corporations, just as the United States treats territorial corporations as "foreign" for the United States tax purposes.[7] Substitutions and omissions were made in the withholding provisions of INT. REV. CODE of 1954, § 1442, on the theory that "Guam should apply the Internal Revenue Code . . . to persons and income within its territory just as the United States applies the Code to persons and income within *its* territory." 395 F.2d at 412.

We apply these concepts to the present problem. The Western Hemisphere trade corporation deduction is a supposedly equalizing economic benefit granted by the United States to American corporations doing most of their business outside the United States in the Western Hemisphere. The stated purpose of the deduction was to alleviate the

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[7] *See* Rev. Rul. 56-616, 1956-2 CUM. BULL. 589-90.

competitive disadvantage thought to be imposed by the surtax of the Revenue Act of 1942 on American corporations trading in the Western Hemisphere.[8] In the light of this purpose, the substitutions urged by the Virgin Islands government would substantially alter and distort the Western Hemisphere trade corporation deduction.

If the United States were the only jurisdiction taxing a mainland corporation deriving 95% of its income from Virgin Islands business, the corporation would be entitled to the Western Hemisphere trade corporation deduction. For, as we already have pointed out, under section 921 the corporation would be "domestic" and its Virgin Islands income would be from "sources without the United States." Therefore, substantive equality of treatment in determining the deduction under the Virgin Islands mirror system requires that the quoted language be given the same meaning. Such identity of treatment imposes no unfairness and creates no distortion. The scheme of the statute is to impose a tax obligation to the Virgin Islands equivalent to what the United States would collect on the same income, but for the mirror system. *Cf. Sayre & Co.* v. *Riddell, supra* at 410-11. To disallow the deduction as the Virgin Islands has done is to claim for the territory a larger tax than the United States would have collected in the absence of the mirror system.

Moreover, if the Virgin Islands can construe "domestic corporation" as used in section 921 to mean a Virgin Islands corporation, but not a mainland corporation, an unwarranted distortion will result in the application of the Western Hemisphere trade corporation deduction. If the regulation treating the Virgin Islands as a source of income outside of the United States is applied, then a Virgin Islands corporation doing all of its business at home can claim the deduction in its Virgin Islands return, the only

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[8] *See* S. Rep. No. 1631, 77th Cong., 2d Sess. 32 (1942), 1942-2 Cum. Bull. 532; 88 Cong. Rec. 7795 (1942).

return it is required to make,[9] while a mainland corporation similarly engaged in the Virgin Islands is denied that privilege. The appellee recognizes that such a distortion must be avoided, so it urges that in determining what local corporations will qualify for the Western Hemisphere trade corporation deduction, the Virgin Islands taxing authorities should substitute the phrase "sources outside of the Virgin Islands" for the statutory phrase "sources without the United States." But that substitution would lead to something far worse. It would enable a Virgin Islands corporation doing most of its business on the mainland to qualify for a deduction intended solely to benefit business activities outside of the United States. Moreover, every business enterprise operating solely on the mainland could qualify for the Western Hemisphere trade corporation deduction merely by incorporating in the Virgin Islands.

Essentially, the Virgin Islands government offers only one contention of social policy to justify the substantive revision of the Western Hemisphere trade corporation deduction it would impose. In an argument accepted by the district court,[10] the local government contends that because the mirror system of taxation was designed to assist the Virgin Islands in becoming financially self-supporting,[11] a Western Hemisphere trade corporation should not receive a subsidy in the form of reduced income tax liability to the Virgin Islands. If valid, this argument would justify elimination of almost any provision of the Internal Revenue Code that enabled a taxpayer to reduce his territorial income tax. However, the Virgin Islands may not at its option effectively disallow the deductions provided in the Internal Revenue Code. *See Guam* v. *Koster, supra.*

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[9] *See* note 1 *supra.*

[10] *See* Chicago Bridge & Iron Co. v. Wheatley, D.V.I. 1969, 295 F. Supp. 240, 242-43.

[11] See Dudley v. Commissioner, 3rd Cir. 1958, 258 F.2d 182, 185.

More basicly, Congress has aided the Virgin Islands by giving them the same tax, not more, than the United States would otherwise collect on Virgin Islands business. We find nothing in the favorable tax treatment granted to Western Hemisphere trade corporations under section 922 of the Internal Revenue Code that is so manifestly incompatible with the concept of an equivalent separate tax imposed by the Virgin Islands as to require modifications altering the substance of the provision.[12]

The judgment of the district court will be reversed, and the case will be remanded with directions to grant the appellant's motion for judgment on the pleadings.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

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[12] Although the wisdom of the deduction has been challenged vigorously, *see, e.g.*, Wilson, *The Western Hemisphere Trade Corporation Act: The Need for Reassessment*, 1968, 2 J. LAW & ECON. DEVELOP. 208, 226-29, such criticism applies equally to the deduction as part of federal and territorial tax law, and does not establish that the deduction is particularly incompatible with a separate territorial tax. We may not rewrite provisions of the territorial tax thereby opposing our judgment to that of Congress.

APPENDIX C

UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

No. 17,838

(D. C. Civil Action No. 237-1967)

Judgment

This cause came on to be heard on the record from the District Court of the Virgin Islands, Division of St. Thomas and St. John and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court, filed February 3, 1969, be, and the same is hereby reversed, and the cause remanded with directions to grant appellant's motion for judgment on the pleadings, in accordance with the opinion of this Court. Costs taxed in favor of appellant.

ATTEST:

/s/ THOMAS F. QUINN
Clerk

July 13, 1970

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* Judge Stahl heard the argument and participated in the consideration of this appeal but died before decision.

APPENDIX D

NAVAL SERVICE APPROPRIATION ACT OF July 12, 1921, c. 44, 42 Stat. 122 (48 U.S.C. 1397):

SEC. 1 *Temporary Government for West Indian Islands:* • • •

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• • • That the income tax laws now in force in the United States of America and those which may hereafter be enacted shall be held to be likewise in force in the Virgin Islands of the United States, except that the proceeds of such taxes shall be paid into the treasuries of said islands.

• • •

INTERNAL REVENUE CODE OF 1954 (26 U.S.C.):

SEC. 921. DEFINITION OF WESTERN HEMISPHERE TRADE CORPORATIONS.

For purposes of this subtitle, the term "Western Hemisphere trade corporation" means a domestic corporation all of whose business (other than incidental purchases) is done in any country or countries in North, Central, or South America, or in the West Indies, and which satisfies the following conditions:

(1) if 95 percent or more of the gross income of such domestic corporation for the 3-year period immediately preceding the close of the taxable year (or for such part of such period during which the corporation was in existence) was derived from sources without the United States; and

(2) if 90 percent or more of its gross income for such period or such part thereof was derived from the active conduct of a trade or business.

For any taxable year beginning prior to January 1, 1954, the determination as to whether any corporation meets the requirements of section 109 of the Internal

Revenue Code of 1939 shall be made as if this section had not been enacted and without inference drawn from the fact that this section is not expressly made applicable with respect to taxable years beginning prior to January 1, 1954.

SEC. 922. SPECIAL DEDUCTION.

In the case of a Western Hemisphere trade corporation there shall be allowed as a deduction in computing taxable income an amount computed as follows—

(1) First determine the taxable income of such corporation computed without regard to this section.

(2) Then multiply the amount determined under paragraph (1) by the fraction—

(A) the numerator of which is 14 percent and

(B) the denominator of which is that percentage which equals the sum of the normal tax rate and the surtax rate for the taxable year prescribed by section 11.

SEC. 7701. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

• • •

(4) *Domestic.*—The term "domestic" when applied to a corporation or partnership means created or organized in the United States or under the law of the United States or of any State or Territory.

(5) *Foreign.*—The term "foreign" when applied to a corporation or partnership means a corporation or partnership which is not domestic.

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APPENDIX E

GOVERNMENT OF
THE VIRGIN ISLANDS OF THE UNITED STATES
CHARLOTTE AMALIE, ST. THOMAS

DEPARTMENT OF FINANCE
TAX DIVISION

October 20, 1970

Honorable Peter J. O'Dea
Attorney General
P. O. Box 280
Charlotte Amalie, St. Thomas,
Virgin Islands 00801

Re: Chicago Bridge and Iron Company, Ltd.
vs. Reuben B. Wheatley
United States Court of Appeals for the
Third Circuit
Decision Filed July 13, 1970

Dear Mr. O'Dea:

At the present time there is pending in our office income tax cases of four United States corporations who have filed returns with the Government of the Virgin Islands covering their taxable income for business done in the Virgin Islands. Each of these corporations has claimed a deduction under Sections 921 and 922 of the Internal Revenue Code as a Western Hemisphere Trade Corporation. This is the only issue involved in each case and the deficiencies proposed by us amount to $411,000.00.

It is difficult to estimate the number of United States corporations that are doing business in the Virgin Islands the same as Chicago Bridge and Iron Company. What is important is that many Virgin Islands corporations that are subsidiaries of United States corporations will reincorporate in the United States if the above decision is not reversed. We have in mind one Virgin Islands corpo-

ration that reported taxable income of $22,869,000. for the year 1969 and paid income taxes of $8,430,370. This corporation is a subsidiary of a United States corporation. There should be no question in anybody's mind that if the foregoing decision is not reversed this Virgin Islands corporation will incorporate in the United States and qualify as a Western Hemisphere Trade Corporation. Thus, it would save over 29% of its income taxes. (Presently, this corporation is entitled to a 75% subsidiary on its income taxes paid, but even with the subsidiary, if this corporation had been a United States corporation it could have a net savings of over $620,000 in income taxes). There is another extremely large corporation, while presently showing losses expects to show profits in the millions in the very near future. Although this taxpayer is presently a Virgin Islands corporation, it may very likely incorporate in the United States for the same reasons.

We have received many inquiries from stateside accounting firms and attorneys as to what the Government of the Virgin Islands intends to do about the Chicago Bridge and Iron Company decision. Practically all of them have expressed the opinion that if this decision is allowed to stand, they will advise their Virgin Islands clients to incorporate in the United States and thus qualify for the Western Hemisphere Trade Corporation deduction even though all of their business is being conducted solely in the Virgin Islands.

Assuming such events occur, it is our estimate that the Government of the Virgin Islands would lose over $7,000,000 per year in corporate income taxes alone. In the fiscal year ending June 30, 1970, corporate income taxes amounted to $20,770,000 and the total income taxes collected by the Virgin Islands amounted to $59,913,000. This probable loss of $7,000,000 would amount to over 11% of all income taxes collected, to over 30% of all corporation taxes, and to 9.6% of taxes from all sources. The mere recitation of these figures and percentages will show the

terrible impact this decision can have on the economy of the Virgin Islands. Our present operating budget is about $75,000,000 and our estimated operating income will be approximately $70,000,000. Furthermore, there are a large number of United States corporations doing business in the Virgin Islands that have not claimed the Western Hemisphere Trade Corporation deduction, but will do so and file claims for refunds if the decision is not reversed.

This information is being submitted to you to show the drastic situation that will confront the Government of the Virgin Islands unless the decision of the Court of Appeals of the Third Circuit in the case of the Chicago Bridge and Iron Company vs. Wheatley is reversed by the Supreme Court of the United States.

Sincerely yours,

/s/ REUBEN B. WHEATLEY
Reuben B. Wheatley
Commissioner of Finance